

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 97-0296 and 97-0297
Indiana Sales/Use Tax
For Tax Years 1992 through 1995

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ISSUES

I. Sales/Use Tax: Equipment and Materials Directly Used or Consumed in Direct Production, Manufacturing, Processing, and Refining

Authority: IC 6-2.5-2-1, IC 6-2.5-3-2, IC 6-2.5-3-4, IC 6-2.5-5-3;
 IC 6-2.5-5-5.1, IC 6-2.5-5-5.1, IC 6-2.5-5-30;
 45 IAC 2.2-5-8(k), 45 IAC 2.2-5-10(k);
 White River Environmental v. Department of State Revenue, 694 N.E.2d 1248
 (Ind.Tax 1998);
 Mechanics Laundry & Supply, Inc. v. Department of State Revenue, 650 N.E.2d
 1223 (Ind.Tax 1995);
 Indianapolis Fruit Co. v. Department of State Revenue, 691 N.E.2d 1379,
 (Ind.Tax 1998);
 Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520 (Ind. 1983);
 Rotation Products v. Department of State Revenue, 690 N.E.2d 795 (Ind.Tax
 1998);
 Faris Mailing v. Dept. of State Revenue, 512 N.E.2d 480 (Ind.Tax 1987);
 General Motors v. Department of State Revenue, 578 N.E.2d 399, 404 (Ind.Tax
 1991).

Taxpayer protests assessments of use tax on various purchases of equipment and materials.

II. Tax Administration: Negligence Penalty

Authority: IC 6-8-10-2.1;
 45 IAC 15-11-2

Taxpayer protests assessment of the negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a waste management facility in Indiana. Taxpayer's primary business activities involve the collection (removal and site cleanup), transport, treatment, and disposal of hazardous and non-hazardous industrial waste materials. Taxpayer analyzes incoming waste

materials to determine the optimal method for treatment and disposal. Treated waste may be recycled as scrap, disposed of in landfills, or transferred to permitted facilities where such waste can be used (consumed) as recycled fuel. Taxpayer also provides site restoration and environmental remediation services.

For the years subject to audit (1992 – 1995), taxpayer failed to self-assess and remit use tax on its taxable purchases. Audit, after reviewing taxpayer records to identify items acquired by taxpayer in retail transactions, proposed assessments of use tax.

Taxpayer now takes exception to Audit’s determinations and ensuing use tax assessments. Specifically, taxpayer claims the proposed assessments are excessive because Audit, in its use tax calculus, failed to exclude purchases exempt from sales/use tax pursuant to IC 6-2.5-5-3 (the equipment exemption), IC 6-2.5-5-5.1 (the consumption exemption), and IC 6-2.5-5-30 (the environmental quality compliance exemption).

DISCUSSION

I. Sales/Use Tax: Equipment and Materials Used or Consumed in Production

Audit disagreed with and dismissed taxpayer’s exemption claims. Audit rejected taxpayer’s conclusions regarding both the impact and relevance of the cited exemptions. “Only taxpayers engaged in the production of tangible personal property,” says Audit, “will qualify for the equipment, consumption, and environmental quality compliance exemptions.” Audit previously had characterized taxpayer’s business activities—conducted primarily at a full service waste treatment, storage, and disposal facility—as those of a *service* provider. And service providers, according to Audit, generally, are not engaged in production activities. Audit reasoned that since this taxpayer *did not produce products for resale*, it could not claim the exemptions.

Taxpayer countered by arguing that it qualified for the exemptions because it was, in fact, engaged in production activities—specifically that of processing and refining. Taxpayer describes its business activities in the following manner:

Taxpayer is engaged in the business of processing and refining hazardous and nonhazardous waste into alternative fuels and metallic by-products. This process involves obtaining certain types of hazardous and nonhazardous waste, removing scrap metal by-products, and converting the waste into an alternative fuel.

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The Taxpayer’s operations involve the conversion of waste materials into useable products including the [f]uel, which is used by cement producers in their kilns, and metallic by-products, which are sold to scrap metal dealers.

To summarize, taxpayer contends that is engaged in “production” because it “wrests usable fuels out of useless liquid and solid waste materials” and “creates value from waste products by extracting and processing usable metallic materials from the waste products.”

Authorities

Indiana imposes a gross retail tax (sales tax) on retail transactions made in Indiana. IC 6-2.5-2-1. Indiana also imposes a use tax on the “storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction.” IC 6-2.5-3-2. Use tax, however, will not be imposed on property stored, used, or consumed in Indiana if sales tax has been paid on the property acquired, or if the property acquired is exempt, pursuant to IC 6-2.5-5, from Indiana sales tax. IC 6-2.5-3-4(a).

There exist within IC 6-2.5-5 a number of sales/use tax exemptions. Manufacturing machinery, tools, and equipment acquired “for the direct use in the direct *production, manufacture, ... processing, refining, or finishing* of other tangible personal property” are exempt from Indiana sales/use tax. See IC 6-2.5-3(b), the “equipment” exemption. Additionally, property acquired “for direct consumption as a material to be consumed in the direct *production* of other tangible personal property in the person’s business of *manufacturing, processing, refining...*” is exempt from Indiana sales/use tax. See IC 6-2.5-5-1, the “consumption” exemption. And property constituting, incorporated into, or consumed in the operation of “a device, facility, or structure predominantly used and acquired for the purpose of complying with any...environmental quality statutes, regulations, or standards” is also exempt from Indiana sales/use tax. See IC 6-2.5-5-30(1), the “environmental quality compliance” exemption. But note: the entity acquiring property for the purpose of complying with environmental quality statutes, regulations, or standards must be “engaged in the business of *manufacturing, processing, refining, mining, or agriculture.*” IC 6-2.5-5-30(2). Emphases added.

These exemption provisions require the taxpayer claiming such exemptions to have been engaged in production activities. “The terms listed in the exemption provisions, i.e., processing, manufacturing, etc., ‘have meaning only to the extent that there is production.’” (The Indiana Tax Court in White River Environmental v. Department of State Revenue, 694 N.E.2d 1248,1250 (Ind.Tax 1998) quoting from Mechanics Laundry & Supply, Inc. v. Department of State Revenue, 650 N.E.2d 1223, 1228 (Ind.Tax 1995).) “If there is no production of goods, the exemption provisions do not apply.” Id. “There is one ironclad rule: without production there can be no exemption.” Indianapolis Fruit Co. v. Department of State Revenue, 691 N.E.2d 1379, 1384 (Ind.Tax 1998). Taxpayer’s entitlement to the cited sales and use tax exemptions depends, therefore, not on whether its activities may be characterized as processing or refining, but on whether taxpayer is engaged in the production of goods or other tangible personal property. (Also see White River Environmental at 1251.)

Regulation 45 IAC 2.2-5-8(k) sheds light on this concept of “production”:

“Direct production, manufacture, fabrication, assembly, or finishing of tangible personal property” is performance as a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. The change in form, composition, or character must be a substantial change, and it must result in a transformation of property into a different product have a distinctive name, character, and use.

Regulation 45 IAC 2.2-5-10(k) provides the following definition of “processing and refining.”

Processing or refining is defined as the performance by a business of an integrated series of operations which places tangible personal property in a form, composition, or character different from that in which it was acquired. ... A processed or refined end product...must be substantially different from the component materials used.

Indiana common law has contributed to the definition of “production”—at least in the context of the sales/use tax exemptions. Indiana courts have identified certain situations in which specific activities will (or will not, as the case may be) constitute production.

For example, the Indiana Supreme Court, in Indiana Dept. of State Revenue v. Cave Stone, 457 N.E.2d 520, 525 (Ind. 1983), found that production had occurred where crude stone, blasted from a quarry, was crushed into aggregate stone. The Indiana Tax Court characterized the exposure of bananas to ethylene gas as “production”. “Although the ripened bananas are still bananas, they have been placed in a ‘form, composition, or character substantially different from that in which [they] were acquired.’ They [the bananas] have been transformed both physically and chemically, and this transformation [ripening] makes a marketable banana from an unmarketable one.” Indianapolis Fruit at 1385. Likewise, the Indiana Tax Court found that the remanufacture of roller bearings constituted production within the meaning of the equipment and consumption exemptions. “[T]his Court finds that RPC [taxpayer] substantially transforms the unusable roller bearings when it remanufactures them and thereby produces other tangible personal property. In other words, a scarce economic good has been created.” Rotation Products v. Department of State Revenue, 690 N.E.2d 795, 804 (Ind.Tax 1998).

On the other hand, the Indiana Tax Court determined that a taxpayer in the business of hauling waste was not engaged in production. “[Taxpayer] simply transports garbage. That it compresses the garbage is irrelevant: to have a colorable claim for the equipment exemption, it would have to compress the garbage as part of its own process to produce other tangible personal property, not as part of an alleged process of another taxpayer.” Indiana Waste Systems of Indiana at 363. And in Faris Mailing v. Dept. of State Revenue, 512 N.E.2d 480 (Ind.Tax 1987), the Indiana Tax Court determined that taxpayer’s assembling of packaging materials on behalf of customers did not constitute “production.” “Regardless of what Petitioner chooses to call his business, ‘production of other tangible personal property’ is required. ... The items used in [taxpayer’s] process cannot reasonably be assumed to transform the customer’s package into a new product.” Id. at 483. The Indiana Tax Court also found that the laundering of soiled textiles does not represent production within the meaning of the equipment, consumption, and environmental compliance exemptions. “The supreme court’s expansive definition of ‘production’ [referring to the Indiana Supreme Court’s Cave Stone opinion], however, in no way negates the requirement that the overall production process, whether it be termed ‘processing’ or otherwise, must result in the production of goods or other tangible personal property. Thus, despite Mechanics Laundry’s [taxpayer’s] attempt to explain its operation in a manner that conforms to the supreme court’s definition of ‘production,’ the laundering of soiled textiles does not constitute ‘production.’” Mechanics Laundry & Supply at 1229.

Issue

At issue, then, is whether taxpayer's activities constitute the production of goods or other tangible personal property. Specifically, whether the *extraction* of scrap metal by-products and the *conversion* of waste materials into alternative fuel represent exempt production activities.

Taxpayer receives hazardous and non-hazardous waste from manufacturers and service providers (i.e., taxpayer's customers). These customers pay taxpayer a fee for accepting their waste. The incoming waste will be analyzed by taxpayer to determine proper treatment and disposal methods. Taxpayer will then treat (if necessary) and dispose of the waste accordingly. Disposal methods vary. Some waste will be buried in landfills; some waste will be segregated and sold (e.g., the scrap metal); and some waste will be treated and transferred, for a price, to others who use the treated waste as fuel for kilns. That is, taxpayer will *pay* others (in this instance, qualified cement manufacturers) to dispose of taxpayer's waste materials.

Conversion of waste into fuel

Taxpayer claims the equipment, consumption, and environmental quality compliance exemptions based upon activities in which taxpayer converts industrial waste into usable fuel. Taxpayer explains:

Taxpayer's various processes clearly are of the type that involve the production of 'other tangible personal property.' The [f]uel results from the transformation of hazardous waste products into a new form that has a valuable use to the Taxpayer's Customers.

With regard to taxpayer's fuel conversion activities, the Department need not parse taxpayer's processes in order to identify indicia of production. The Department need not determine whether taxpayer's activities transform hazardous waste into usable fuel. The Department need not perform such analyses because taxpayer does not *sell* usable fuel. Rather, taxpayer *pays* others to accept and dispose of such fuel. Absent the creation of a marketable product, taxpayer cannot have been engaged in production. The "marketable" moniker, of course, is a function of sales; if the fruits of taxpayer's labors are not sold, a marketable product cannot have been produced. Case law supports this commonsense conclusion.

The Indiana Tax Court indicated the close relationship between sales and the concept of "marketability" in its Indianapolis Fruit opinion when it stated:

Most of these fruits and vegetables require little in the way of *processing before resale* because they are in a *marketable* condition when Indianapolis Fruit [the taxpayer] receives them. That is not the case with bananas and tomatoes; when Indianapolis Fruit [taxpayer] receives them, they are not marketable, and they require additional processing to put them into that condition. Emphasis added. *Id.* at 1381.

The Indiana Tax Court in White River Environmental, after stating the maxim that production "is defined broadly and focuses on the creation of a marketable product," wrote:

Despite the possibility that the clean water, ash, and sludge created by WREP's [taxpayer's] waste treatment process may be sold in the future, the fact remains that those

byproducts are not sold in the present. Accordingly, they remain the byproducts of a useful service, not goods for the marketplace. See Indiana Dep't of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520, 524 (1983) (production encompasses all activity directed to increasing the number of scarce economic goods, i.e., *goods to be sold in the marketplace*). Emphasis added.

So, regardless of the endeavor taxpayer professes to be engaged in, it cannot be characterized as “production.” Even though taxpayer’s treatment of industrial waste permits taxpayer to *dispose* of its waste in a more economical manner, such effects, for purposes of the claimed exemptions, will not serve to transform “treatment” into “production.”

Recapture of metallic by-products

Taxpayer contends “extraction” of metallic by-products from industrial waste and the subsequent sale (as scrap) of such by-products represent, collectively, production for purposes of the equipment, consumption, and environmental quality compliance exemptions. Taxpayer states “[these] exemption[s] appl[y] to all equipment used and materials consumed as ‘an essential and integral part of an integrated production process’ which produces metallic by-products.”

Taxpayer, in this instance, *sells* tangible personal property. Taxpayer *sells* the collected metallic by-products for scrap. Taxpayer, however, does not create a *processed* or *refined* end product. Taxpayer does not place “tangible personal property in a form, composition, or character different from that in which it was acquired.” 45 IAC 2.2-5-10(k). Rather, the metallic by-products are *recovered* from industrial waste materials. Such activity does not represent, as taxpayer claims, the selling of byproducts *produced* in the course of taxpayer’s business. Taxpayer’s labors result in neither a “different product” nor a “refined end product...substantially different from the component materials used.” 45 IAC 2.2-5-10(k) and 45 IAC 2.2-5-8(k). Consequently, taxpayer’s recovery and collection of metallic by-products from industrial waste cannot, regardless of the label used by taxpayer (e.g., manufacturing, processing, or refining), represent production.

Conclusion

The legislature intended the exemptions at issue to be available only to those engaged in the production of goods or other tangible personal property. See General Motors v. Department of State Revenue, 578 N.E.2d 399, 404 (Ind.Tax 1991) and Mechanics Laundry at 1230. Taxpayer, however, is not engaged in production. Taxpayer produces neither goods nor other tangible personal property. Rather, taxpayer transports, treats, and disposes of hazardous and non-hazardous industrial waste materials. Pursuant to statute, regulation, and relevant case law, taxpayer will not qualify for and may not claim the equipment, consumption, and environmental quality compliance exemptions.

FINDING

Taxpayer’s protest is denied.

II. Tax Administration: Negligence Penalty

The Department may impose, in certain situations, a ten percent (10%) negligence penalty. IC 6-8-10-2.1 and 45 IAC 15-11-2. Taxpayer's failure to report and remit use tax generally will result in penalty assessment. IC 6-8.1-10-2.1(a)(1). The Department, however, will waive this penalty if taxpayer can establish that its failure to file "was due to reasonable cause and not due to negligence." 45 IAC 15-11-2(c). A taxpayer may demonstrate reasonable cause by showing "that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed...." *Id.* Taxpayer has failed to make such a showing.

FINDING

Taxpayer's protest is denied.

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